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September 7, 2009

Ms. Joan Agostinelli
Office Chief
Arizona Department of Health Services
Office for Children with Special Health Care Needs
Children's Rehabilitative Services
150 N. 18th Avenue, Suite #330
Phoenix, AZ 85007-3243

Final and Confidential

Subject: Title XIX, Title XXI and Proposition 204 Capitation Rates for Contract Year 2010

Dear Ms. Agostinelli:

The Arizona Department of Health Services (ADHS), Office for Children with Special Health Care Needs (OCSHCN), Children's Rehabilitative Services (CRS) program contracted with Mercer Government Human Services Consulting (Mercer), part of Mercer Health & Benefits LLC to develop capitation rates for the Title XIX, Title XXI and Proposition 204 populations. These rates are used by the Arizona Health Care Cost Containment System (AHCCCS) to compensate CRS and the CRS contractor for CRS members who are Title XIX, Title XXI or Proposition 204 eligible during the Contract Year. For the Contract Year beginning October 1, 2009, and ending September 30, 2010 (CYE 2010), Mercer has developed capitation rates following the process described in this letter.

Background

CRS is primarily a children's program for Arizona residents under the age of 21 with chronic and disabling, or potentially disabling, conditions. The program provides services through one statewide contractor. Medical services not related to a child's CRS-eligible condition are provided through the child's AHCCCS health plan.

Three capitation rates are developed for compensating the CRS contractor based upon a member's CRS enrollment diagnosis. The three rates represent compensation for providing services to members with specific diagnoses that have historically represented relatively high, medium and low costs to the CRS contractor. The High, Medium and Low capitation risk group structure includes small numbers of the Qualified Medicare Beneficiary (QMB)

Plus, Medicaid [non-QMB and non-Specified Low-income Medicare Beneficiary (SLMB)], and SLMB Plus dual eligible populations. No other dual eligible populations are enrolled in the program. In Mercer's opinion, the High, Medium and Low capitation rate cells most appropriately match payment with risk in the CRS program, and hence provide a greater level of actuarial soundness than other approaches. The three-tier rate structure will continue to be used for CYE 2010.

CYE 2010 Capitation Rate Development Methodology – Overview

CYE 2010 marks the fifth year that contractor encounters have been used as the base data source. The CYE 2010 rates have been re-based.

Base Data

The State Fiscal Years (SFYs) 2007 and 2008 contractor encounter data were valued using a combination of contractor paid amounts and Medicaid (AHCCCS) fee schedule allowed amounts, incorporating a methodology in conjunction with Third Party Liability (TPL) cost avoidance and any pay-and-chase recoveries. SFY 2007 encounters were trended forward to a "modeled SFY 2008" level, and blended with the actual SFY 2008 encounters to further enhance the credibility of the base data.

With three years of encounter data, SFY 2006 through SFY 2008, CRS Administration and Mercer performed a thorough analysis and kept the High, Medium and Low diagnostic groupings consistent with the prior year.

The CRS program falls under Arizona's 1115 waiver. Mercer performed a review of the CRS subcontractor submitted data and determined that the data included a small amount of non-covered services which have been excluded from the base data.

Base Data Adjustments

1. Unpaid Claims Liability

The SFYs 2007 and 2008 base data consist of encounters with dates of service beginning July 1, 2006, and ending June 30, 2008. Encounters were analyzed with a run-out period of nine months beyond the June 30, 2008, endpoint, with data extracted in early April 2009.

The next step in the base data analysis process was a review of the CRS contractors' expense component for claims incurred but unpaid, hereinafter called the unpaid claims liability (UCL). The UCL is the sum of claims incurred but not reported, plus those claims reported but not yet paid. Statutory accounting recognizes an incurred medical expense for the period as the result of the sum of claims paid in the period, plus the change in the accrued liability for the UCL between the beginning and the end of the period. This calculation pushes the correction of the estimation error of the beginning UCL into the expense recognized in the current period. However, the expense that should be recognized in base data development is calculated from claims incurred in the SFYs 2007 and 2008 experience period, both claims paid in SFYs 2007 and 2008 and the accrued liability for the UCL as of the end of SFY 2008.

A review of the contractors' SFY 2008 encounters indicated that there were outstanding claims as of the early April 2009 data extract. The overall adjustment for SFY 2008 encounters received beyond the early April 2009 data extract was approximately $0.4 million, or 0.3 percent over the two-year base period.

2. Completion for "Omissions"

As part of its 1115 waiver provisions, AHCCCS performs annual data validation studies of encounters. AHCCCS tests for completeness, accuracy and timeliness of encounter submissions based upon statistically valid sampling of both professional and facility encounters, comparing them against medical records. Mercer used the results of the most recently completed data validation study to develop factors to apply to the base CRS data to further complete the encounters for these "omissions." Mercer and CRS Administration used (with some downward adjustment which lowered the overall impact) the factors shown by AHCCCS, which vary between facility and professional consolidated categories of service (COS). The overall rate impact of this correcting adjustment is approximately $3.8 million, or 3.0 percent combined for both SFYs 2007 and 2008 data.

3. "Non-encounterable" Costs

In addition, the adjusted base SFYs 2007 and 2008 data reflects contractor costs not captured by encounters, but typically considered under medical service expenses rather than administrative expenses. These "non-encounterable" costs include those for such providers as social workers and interpreters, as well as telephone and tele-video interventions, counseling, care coordination activities and member/family education. The overall

non-encounterable adjustment is approximately $1.4 million, or 1.1 percent of the base SFYs 2007 and 2008 encounters.

4. AHCCCS Inpatient Outlier Methodology Change

Starting on October 1, 2007, AHCCCS began a three-year phase-in of a new inpatient outlier methodology (specific to the cost-to-charge ratios used to qualify and pay outliers). CYE 2010 marks Year 3 of the phase-in, so the outliers in the base SFY 2007 and SFY 2008 encounters were re-priced using the new methodology. This change reduced the two-year base data by approximately $9.6 million, or 6.9%.

The following table summarizes the adjustments to the two-year base data.

Base Data Adjustment	Dollar Impact	Percent Impact
Unpaid Claims Liability	$0.4 million	0.3%
Completion for “Omissions”	$3.8 million	3.0%
“Non-Encounterable” Costs	$1.4 million	1.1%
IP Outlier Methodology Change	($9.6 million)	(6.9%)

Trend to CYE 2010

The SFY 2007 trended (modeled SFY 2008) and SFY 2008 encounter cost data were trended forward 27 months to CYE 2010. The trend factors recognize changes in cost-per-service unit and utilization of health care services from the SFYs 2007 and 2008 base period to CYE 2010. Unique trends were applied separately for ten COS. Trends were developed separately for the first 15 and last 12 months of the 27-month period to account for the unit cost rate caps and reductions mandated by the State legislature effective on October 1, 2008 and 2009. Inpatient and outpatient facility unit cost were frozen at 0.0% for both CYE 2008 and 2009, while most of the COS unit cost trends reflect a -5.0 percent reduction effective October 1, 2009. The weighted annual trend adjustment for SFY 2007 and SFY 2008 to CYE 2010 was 4.7 percent (2.6 percent utilization and 2.1 percent unit cost).

Mercer relied heavily on historical CRS encounter information as well as its professional experience in working with other state Medicaid programs, outlooks in the commercial marketplace that influence Medicaid programs, regional and national economic indicators, and general price/wage inflation in developing trends. The 4.7 percent annualized weighted

trend compares favorably (is lower than) historical experience trend. Mercer believes the final trend factors selected to be reasonable and appropriate.

Service Utilization and Technology Changes from Base Data to CYE 2010

Service utilization increases and technology changes not reflected (or not fully reflected) within the SFYs 2007 and 2008 base data will impact the CRS contractor for CYE 2010. Adjustments for CYE 2010 were made for the following items through analyzing data from CRS, the AHCCCS contractors and external sources.

1. Biotech Drugs

Effective CYE 2009, the coverage of the high-cost drugs Aldurazyme, Cerezyme, Elaprase, Fabrazyme, Myozyme and Orfadin was transferred from AHCCCS to CRS. The total impact of these changes is approximately $2.5 million, or 1.9 percent, over the two-year base period.

2. Cochlear Implants

Effective CYE 2009, the coverage of cochlear implants and related services was transferred from AHCCCS to CRS. The total impact of this change is approximately $1.9 million, or 1.7%, over the two-year base period.

3. Motorized Wheelchairs

Effective CYE 2009, the coverage of motorized wheelchairs related to CRS eligible conditions was transferred from AHCCCS to CRS. The total impact of this change is approximately $0.4 million, or 0.3%, over the two-year base period.

4. CRS Related Conditions

Effective CYE 2009, the coverage of conditions related to or caused by CRS conditions (e.g., diabetes caused by cystic fibrosis and failure to thrive caused by Cerebral Palsy) was transferred from AHCCCS to CRS. The total impact of this change is approximately $0.1 million, or 0.1%, over the two-year base period.

5. Therapies

Effective CYE 2009, the CRS limit of 24 therapy sessions was lifted. The total impact of lifting the limit is estimated to be $10,000, or less than 0.1 percent, over the two-year base period.

6. Emergency Services

The new CRS contractor has a significantly expanded hospital network as compared to the previous contractors which comprise the SFYs 2007 and 2008 base data. As a result of this, the Contractor is financially responsible for coverage of the related emergency services (that result in an inpatient admission) in those facilities effective CYE 2009, previously covered by AHCCCS non-CRS Contractors. The total impact of this change is $1.2 million, or 1.0%, over the two-year base period.

7. Transfer Outpatient Emergency Services to AHCCCS

Costs for outpatient emergency services, which do not result in a hospital admission will be transferred from the CRS contractor to the AHCCCS contractors effective October 1, 2009. The total impact of this change is approximately $0.1 million, or 0.1%, over the two-year base period.

The following table summarizes the future benefit adjustments to the two-year base data.

Benefit Adjustment	Dollar Impact	Percent Impact
Biotech Drugs	$2.5 million	1.9%
Cochlear Implants	$1.9 million	1.7%
Motorized Wheelchairs	$0.4 million	0.3%
CRS Related Conditions	$0.1 million	0.1%
Therapies	$10,000	< 0.1%
Emergency Services	$1.2 million	1.0%
OP ER Transfer to AHCCCS	($0.1 million)	(0.1%)

Loading for Contractor Administration and Underwriting Profit/Risk/Contingency

The overall CYE 2010 administrative expense load for the CRS Contractor is 9.6 percent. This is down slightly from the comparable CYE 2009 figure of 10.2 percent.

An underwriting profit/risk/contingency loading of 1.5 percent was applied uniformly to all rates. There should be an assumed margin for contribution to entity surplus and adverse claim risk contingency. The 1.5 percent represents a 0.5% reduction from CYE 2009 and follows similar reductions applied to AHCCCS acute care contractors.

CRS Administration

AHCCCS has placed CRS Administration at risk for the provision of CRS-covered services for CYE 2010. Accordingly, the capitation rates were developed to include compensation to CRS for the cost of ensuring the delivery of all CRS covered services. The capitation rates paid to CRS include a 5.6 percent administrative load. This is down from the 7.7 percent load for CYE 2009. The administrative load represents the CRS costs of ensuring the efficient delivery of services in a managed care environment, and is based upon historical CRS costs and accounts for continued regulatory oversight cost expectations for CYE 2010.

Reinsurance Offset

CRS Administration has negotiated a reinsurance arrangement with AHCCCS for CYE 2010 that remains the same as it was in CYE 2009. The arrangement covers inpatient claims exceeding $75,000 at 75 percent reimbursement. It also covers the high-cost biotech drugs Aldurazyme, Cerezyme, Elaprase, Fabrazyme, Kuvan, Myozyme and Orfadin at 85 percent reimbursement. Mercer estimated the value of the reinsurance through analyzing data from CRS, the CRS contractor, the AHCCCS contractors, and external sources. Reimbursement amounts were estimated for the High, Medium and Low risk groups for SFY 2007 and SFY 2008 and each was trended forward to the CYE 2010 time period. These totals were then blended using a 50-50 weighting on projected SFYs 2007 and 2008 base data.

Certification of Rates

In preparing the Title XIX, Title XXI and Proposition 204 CRS capitation rates shown below, Mercer has used and relied upon enrollment, eligibility, claim, reimbursement level, benefit design, and financial data and information supplied by the State. The State is responsible for the validity and completeness of this supplied data and information. Mercer reviewed the data and information for internal consistency and reasonableness but did not audit it. In Mercer's opinion it is appropriate for the intended purposes. If the data and information are incomplete or inaccurate, the values shown in this report may need to be revised accordingly.

Mercer certifies that the CYE 2010 rates, including any risk-sharing mechanisms, incentive arrangements, or other payments, were developed in accordance with generally accepted actuarial practices and principles and are appropriate for the Medicaid covered populations and services under the CRS contract. The undersigned actuary is a member of the American Academy of Actuaries and meets its qualification standards to certify to the actuarial soundness of Medicaid managed care capitation rates.

Rates developed by Mercer are actuarial projections of future contingent events. Actual Health Maintenance Organization (HMO) costs will differ from these projections. Mercer has developed these rates on behalf of the State to demonstrate compliance with the Centers for Medicare and Medicaid Services (CMS) requirements under 42 CFR 438.6(c) and accordance with applicable law and regulations. Use of these rates for any purpose beyond that stated may not be appropriate.

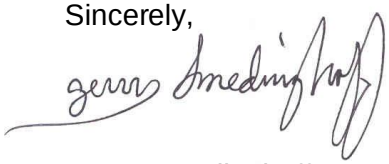
HMOs are advised that the use of these rates may not be appropriate for their particular circumstance and Mercer disclaims any responsibility for the use of these rates by HMOs for any purpose. Mercer recommends that any HMO considering contracting with the State should analyze its own projected medical expense, administrative expense, and any other premium needs for comparison to these rates before deciding whether to contract with the State.

This certification letter assumes the reader is familiar with the CRS program, Medicaid eligibility rules, and actuarial rating techniques. It is intended for the State and CMS, and should not be relied upon by third parties. Other readers should seek the advice of actuaries or other qualified professionals competent in the area of actuarial rate projections to understand the technical nature of these results.

Risk Category	High	Medium	Low
Statewide Rates	$933.02	$554.01	$207.68
AHCCCS Reinsurance	($100.53)	($17.39)	($1.26)
Net Rates After Reinsurance	$832.49	$536.62	$206.42

If you have any questions or would like to discuss this information further, please call me at 602 522 6555.

Sincerely,



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Attachments